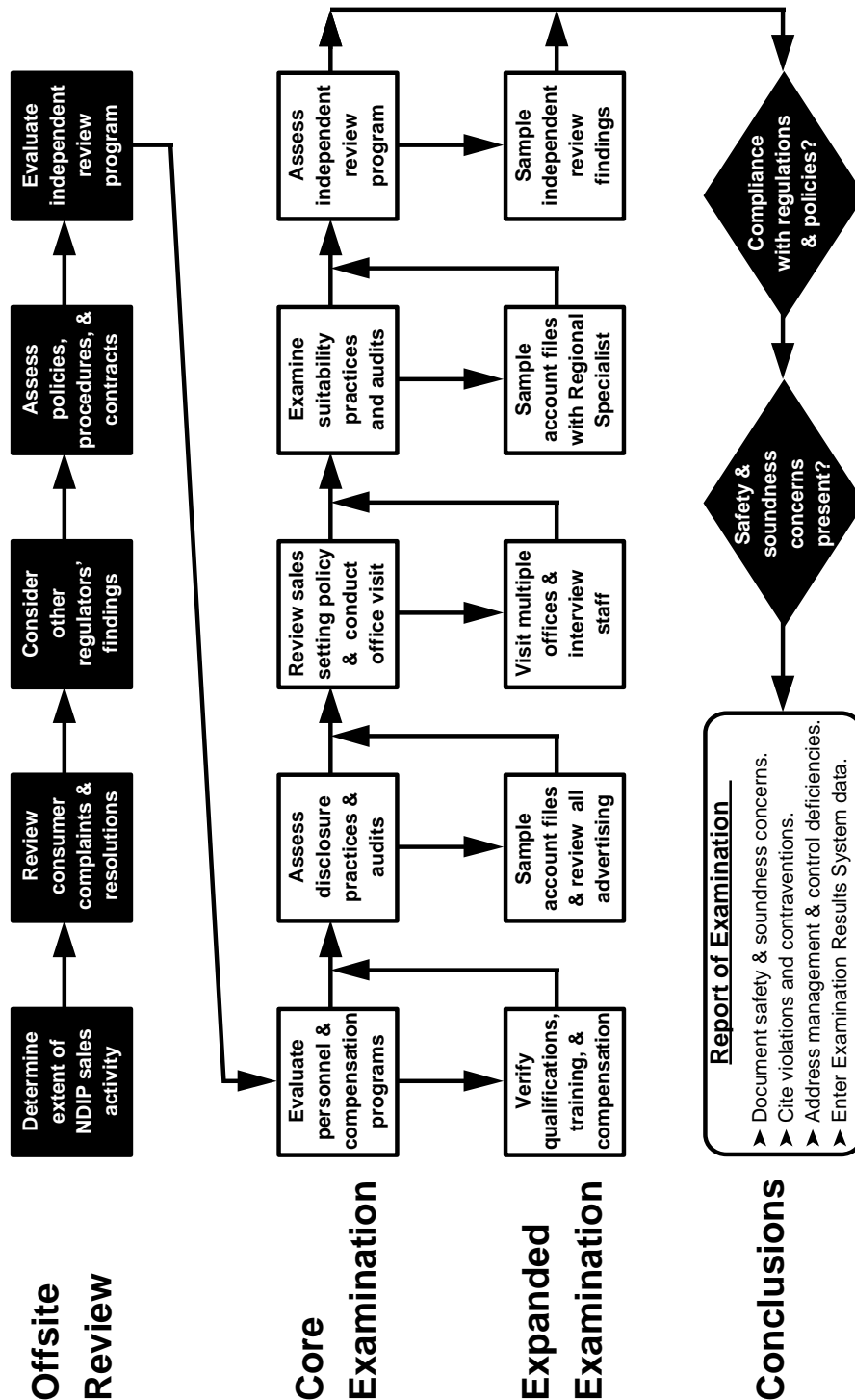


NONDEPOSIT INVESTMENT PRODUCT EXAMINATION PROCEDURES

Examination Process



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I. INTRODUCTION

A nondeposit investment product (NDIP) is a financial asset that is not FDIC-insured and may contain investment risk. NDIPs include mutual funds, annuities, securities, and self-directed Individual Retirement Accounts that invest in securities. NDIP sales can expand banks' activities, bolster earnings, increase competitiveness, and provide customers with additional services. NDIP sales at insured depository institutions may potentially confuse customers and expose banks to contingent liability or reputation risk. In addition, NDIP activity may materially affect banks' earnings or funding structures. Therefore, examiners must carefully evaluate NDIP sales activities.

Several FDIC regulations govern NDIP activity, including minimum recordkeeping and confirmation requirements (Part 344), subsidiary and affiliate activities (Part 337.4), and advertisement of membership standards (Part 328). In addition, on February 15, 1994, the four federal financial institution regulatory agencies issued the Interagency Statement on Retail Sales of Nondeposit Investment Products (Interagency Statement). The Interagency Statement applies to all insured depository institutions engaged in retail NDIP sales, regardless of whether they sell NDIPs directly or through an arrangement with a third party. The Interagency Statement declares that banks should fully inform customers about NDIP risks, differentiate NDIPs from insured deposits, distinguish the NDIP sales area from the retail deposit area, develop effective program management, and establish independent compliance review.

Notably, the Interagency Statement does not apply to trust activities (when trust powers are exercised), savings bond sales, and government and municipal security sales in segregated dealer departments. The Interagency Statement applies to retail NDIP sales effected by trust departments when trust powers are not exercised.

The following guidance enables examiners to efficiently assess adherence to applicable regulations and the Interagency Statement, and to determine any safety and soundness risks that result from NDIP activities. The examination procedures emphasize offsite review and automated processes. At examiners' discretion, the examination scope for any NDIP area may be expanded to permit more detailed review. However, expansion of the examination's scope should be restricted only to the specific areas that require additional scrutiny. Examination resources should be targeted on specific areas of concern.

II. NDIP CONCEPTS

LAWS, REGULATIONS, AND SUPERVISION

Blue sky laws are state securities laws, which can vary considerably between states.

The Employee Retirement Income Security Act (ERISA) governs most private pension and benefit plans and establishes pension fund management guidelines. ERISA provisions apply to self-directed IRAs and Keogh accounts.

The Glass-Steagall Act (Glass-Steagall), enacted in 1933, generally prohibits banks from underwriting securities, engaging in investment banking, or affiliating with investment banks. It also restricts securities firms' retail banking activities.

The Investment Company Act of 1940 requires investment companies to register with the SEC, and establishes requirements for reporting, pricing, investment allocations, and marketing.

The Investment Advisers Act of 1940 requires all investment advisers to register with the SEC and protects investors from misrepresentation.

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The Securities Act of 1933 requires registration of securities offered for public sale, mandates preparation of a prospectus that contains adequate disclosures, and prohibits false statements or fraud.

The Securities Exchange Act of 1934 authorizes the SEC to maintain fair and orderly securities markets and enforce the Securities Act of 1933. It also established disclosure, registration, and insider trading requirements.

The National Association of Securities Dealers (NASD) is the self-regulatory organization for the over-the-counter securities market. It establishes member qualifications, tests and licenses representatives, maintains Rules of Fair Practice, and enforces compliance with securities laws and its own rules (subject to SEC review).

NASD licenses, earned after passing standardized examinations, permit holders to engage in prescribed activities. Several licenses are summarized below:

Series 6: Investment Company and Variable Contract Products Limited Representative, authorized to sell only mutual funds and annuities.

Series 7: General Securities Representative, may sell all securities except commodities.

Series 11: Assistant Representative - Order Processing, can take and enter unsolicited orders, but can not determine suitability or provide investment recommendations.

Series 24: General Securities Principal, authorized to supervise all sales personnel.

Series 52: Municipal Securities Representative, may sell only municipal and government securities.

Series 62: Corporate Securities Limited Representative, may sell only corporate obligations.

Regulatory enforcement authority is divided between several banking and securities regulators.

Entity Effecting NDIP Sales	Primary Federal Regulator
State Nonmember Bank	FDIC
State Member Bank	FRB
Bank Holding Company	FRB
National Bank	OCC
Broker / Dealer	SEC & NASD

The Securities and Exchange Commission (SEC) was created by Congress to protect investors, maintain fair and orderly securities markets, and enforce federal securities laws.

The Securities Investor Protection Corporation (SIPC) is a nonprofit membership corporation chartered by Congress to protect brokerage clients should their securities firm declare bankruptcy. Individual investors receive \$500,000 coverage for cash and securities held by brokerages (but coverage for cash is limited to \$100,000). This coverage does not apply to losses that result from investment risk. Banks are ineligible for SIPC membership, so direct bank NDIP program customers may not receive SIPC coverage. Bank subsidiaries and affiliates that register

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as broker/dealers are eligible for SIPC membership.

Senior Regional Capital Markets and Securities Specialists (SRCMSS) are official FDIC specialists for a broad range of capital markets topics, including NDIPs, bank investment securities, market risk, and derivatives. One SRCMSS is assigned to each Region and serves as the primary contact between examiners and the Division of Supervision's Securities, Capital Markets, and Trust Branch. SRCMSS and other designated examiners, referred to as Regional Capital Markets and Securities Specialists (RCMSS), receive intensive specialized training. Securities and capital markets questions, including NDIP concerns, should be directed to a SRCMSS or a RCMSS.

TERMINOLOGY

Annuities are contracts that guarantee income (typically for an individual's lifetime) in exchange for a lump sum or periodic payment. The terms are usually based upon the individual's expected lifetime and anticipated market conditions.

Deferred annuities guarantee payments at a specified future date and for a specified period.

Fixed annuities are insurance products that guarantee fixed dollar payments, typically until death. The insurance company guarantees both earnings and principal. Fixed annuities are generally not considered securities, contain credit risk, and are regulated by state insurance commissioners.

Immediate annuities are purchased with a single premium, and begin paying at once.

Variable annuities guarantee payments, but do not guarantee the payment amounts. Variable annuities are securities, contain investment risk, and investors select level of investment risk.

Bank securities representatives are bank employees who solicit, recommend, and effect NDIP transactions for retail customers within an insured depository institution's direct NDIP program. Bank securities representatives' qualifications and training should substantively satisfy the equivalent NASD license's requirements. Dual and third-party employees are not bank securities representatives.

Brokers charge a fee or commission for executing customer transactions, or for providing services (for example, investment advice). Federal securities laws exempt banks from the definition of a broker.

Dealers act as a principal in a transaction. A dealer buys or sells a security for its own account and charges the customer a premium or discount. Federal securities laws exempt banks from the definition of a dealer.

Discount brokers simply execute transactions and maintain customer accounts, but do not provide investment advice. All discount brokerage transactions are unsolicited.

Dual employees are employed by both the bank and a third-party. Management and compensation arrangements vary, but dual employee programs should be governed by written agreements that clearly describe each party's responsibilities.

Full-service brokers provide complete investment services, including investment advice, in exchange for fees or commissions.

Hybrid accounts, which include sweep accounts, combine elements of insured deposits and NDIPs. The Interagency Statement's guidelines generally apply to hybrid accounts.

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Independent review functions should be performed by individuals that are not involved in any part of the NDI P operation. Reviews may be conducted by internal auditors, external auditors, or other independent staffers.

Investment advisers include any individual who offers investment advice in exchange for compensation. Federal securities laws exempt banks from the definition of an investment adviser.

Keogh accounts are tax-deferred pension accounts, but are available only to the self-employed or employees of unincorporated businesses.

Load refers to the sales charge paid by an investor who purchases mutual fund shares or annuities. *Front-end loads* are charged at purchase, while *back-end loads* are charged at sale. However, many funds do not charge sales fees (*no-load funds*). *12b-1 mutual funds* are usually no-load, but assess shareholders for promotional expenses. Charges typically total less than 1 percent of fund assets per year. 12b-1 funds must register with the SEC and disclose their fees.

Mutual funds are investment companies that register under the Investment Company Act of 1940. Mutual funds offer their own shares for sale or have outstanding shares that are redeemable at the net asset value. All owners share gains and losses on a pro rata basis. Mutual funds are segregated into two categories:

Open-end funds are sold through a continuous share offering. Share price equals the net asset value, plus any sales fees. Shares are redeemable at the net asset value, less any redemption fees.

Closed-end fund shares are traded like equities, usually on an exchange. The number of shares is fixed, price is determined by the secondary market, and shares are not typically redeemed.

Mutual fund administrators perform various services for mutual funds, such as disbursements, auditing, legal counsel, and information distribution.

Mutual fund distributors are broker/dealers that act as mutual fund agents to sell fund shares. Distributors' responsibilities include SEC registration, prospectus distribution, and marketing.

Mutual fund custodians physically safeguard fund securities.

Net asset value (NAV) represents a mutual fund's share value. It is calculated by subtracting total liabilities from total assets, then dividing by the number of outstanding shares. The NAV is calculated once per day, after each asset in the fund's portfolio is priced at the market close.

Networking arrangements are formal agreements between banks and third-party vendors that enable vendors to sell or recommend NDIPs on bank premises. A written contract formalizes the arrangement, including compensation, personnel, facilities usage, and other responsibilities.

Private label investment products are NDIPs not affiliated with the bank, but marketed exclusively through that bank. The investment advisor, administrator, and distributor are not bank affiliates.

Proprietary products are NDIPs that the bank or bank affiliate advises and markets principally to bank or affiliate customers.

Sales representatives recommend or sell NDIPs on bank premises. Sales representatives may be NASD-licensed registered representatives or bank securities representatives.

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Self-directed individual retirement accounts (IRAs) permit account holders to select the investments held in their accounts. Accounts may be designated trustee or custodian accounts, and bank management's responsibilities vary accordingly. The Interagency Statement does not apply to self-directed IRAs that are invested entirely in insured deposits or that are part of a formal trust agreement (trustee accounts).

Securities are financial instruments that grant an ownership position (stocks), a creditor relationship (bonds), or the right to purchase an ownership position (options, rights, and warrants). Securities contain investment risk and investors may lose part or all of their invested principal.

Sweep accounts include any accounts that employ prearranged, automatic funds transfers (above a preset dollar balance) from a deposit account to purchase securities. Sweep accounts also include accounts that use prearranged, automatic securities sales or redemptions to replenish a deposit account that falls below a preset dollar balance.

Third-party vendors are entities other than banks that engage in NDIP activity on bank premises. Bank subsidiaries or affiliates engaged in NDIP activities are considered third-party vendors.

Unsolicited transactions occur when customers direct sales representatives to initiate transactions that were not recommended or suggested by any individual connected with the NDIP operation.

III. PROGRAM MANAGEMENT

Management's responsibilities depend upon the type and scope of the bank's NDIP operation. When bank employees sell or recommend NDIPs, management must establish a comprehensive program to control and supervise all aspects of the program's daily operations. If the bank has a networking arrangement with a third-party vendor, then management's responsibilities depend upon the nature and scope of the networking arrangement and management's oversight program for that relationship. Regardless of the type of NDIP operation employed, management must ensure that:

- NDIP activity adheres to all laws, regulations, and the Interagency Statement.
- The NDIP program operates safely and soundly.
- Customers receive adequate disclosures.

Board Oversight

The board should adopt an NDIP statement that addresses the program's risks and ensures compliance with the Interagency Statement. The NDIP statement should summarize the program's policies, procedures, and controls. It should clearly define the scope of any third party activities and bank monitoring of third party compliance with applicable laws, regulations, and the Interagency Statement. The statement should contain detail commensurate with the NDIP program's scope. The board should formally adopt the statement, review it periodically, and revise it when appropriate.

Bank Operations

When bank employees recommend or sell NDIPs, management should adopt a comprehensive NDIP management program. The program should be guided by board policy, include detailed procedures, and receive close management supervision. The board should tailor its NDIP program to the bank's goals and its customers' needs. Most important, the board should periodically reassess the program and, when necessary, modify it to ensure prudent oversight of all NDIP activities. Management's policies and procedures should:

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- Ensure compliance with all applicable laws, regulations, and the Interagency Statement.
- Designate the senior managers responsible for supervising NDIP activity.
- Designate the employees authorized to recommend or sell NDIPs.
- Maintain strict separation of duties between NDIP sales, management, and accounting.
- Establish procedures and criteria for selecting and reviewing the NDIPs offered.
- Set guidelines for customer information usage.
- Establish NDIP referral procedures.
- Detail employee qualification, training, and compensation practices.
- Ensure that the bank's blanket bond covers its NDIP activities.
- Establish a process to document and resolve customer complaints.

Networking Arrangements

Prior to entering into a networking agreement with a third-party vendor, management should diligently review the third party's:

- | | |
|----------------------|---|
| ➤ Qualifications | ➤ Financial condition |
| ➤ Experience | ➤ References (particularly other banks) |
| ➤ Regulatory history | |

Networking arrangements should be established by a formal, written agreement. The board should periodically review its third party agreements to ensure that they meet the bank's needs and conform to all regulatory requirements. Networking agreements should:

- Clearly describe each party's duties and responsibilities.
- Define the activities that may be conducted on bank premises.
- Establish controls for the use of bank space, personnel, and equipment.
- Establish sales representative qualification requirements.
- Not preclude management from determining if particular sales representatives are not qualified to be associated with the NDIP program.
- Detail all compensation arrangements for all related personnel.
- Require the third party to comply with all applicable laws, regulations, and the Interagency Statement.
- Authorize the bank and appropriate banking agencies to monitor, review, and verify third party compliance and records.
- Indemnify the bank from liability resulting from the third party's NDIP sales activities.
- Require written, bank-approved employment contracts for any dual employees.
- Address the use of customer information and safeguard protected information.

Subsidiaries and Affiliates

NDIP subsidiaries and affiliates are third parties; therefore, they are subject to all third-party vendor requirements and guidelines. The board's policies should ensure that the bank complies with Part 337.4 of the FDIC's Rules and Regulations, which governs bank subsidiaries' securities activities and bank transactions with affiliated securities firms.

Product Selection

Management should offer NDIPs that meet the bank's goals and anticipated customer needs. Policies should specify the criteria used to select the NDIPs that will be sold. That process should be scrupulously followed and documented. At a minimum, management should:

- Determine if and how products are regulated.
- Assess each product's risks, rewards, and long-term performance.

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- Consider the reputation and financial strength of the issuing or sponsoring company.
- Periodically review the product mix relative to the bank's goals and customer needs.

When a consultant or third-party selects or recommends the product mix, management should verify that the selection process includes the above provisions. Further, management should determine if the consultant or third party receives compensation from any product provider. Management should carefully consider any compensation arrangements before offering those products.

IV. PERSONNEL

NDIP programs can not operate safely and soundly without qualified employees. Management should establish formal policies and requirements for bank securities representatives, the bank's NDIP supervisory personnel, and other bank NDIP program employees. Those policies and requirements should address:

- Qualifications
- Training
- Compensation

Qualifications

When bank employees recommend or sell NDIPs, management should ensure that its employees are qualified and adhere to high professional standards. Bank securities representatives should possess qualifications that are substantively equivalent to NASD-licensed registered representatives. Management should verify each bank securities representative's background with regulatory agencies and prior employers. Securities regulators and self-regulatory organizations maintain historical records of disciplinary and formal enforcement actions taken against representatives. When a bank securities representative has a history of formal enforcement actions, management should carefully consider whether that individual should be associated with the bank's NDIP program.

When the bank has a networking arrangement with a third party, management should take every reasonable precaution to verify that sales representatives on bank premises are properly licensed, qualified, and professional. For both dual employees and third-party employees, management should verify each sales representative's background with regulatory agencies and prior employers. When a representative has a history of formal enforcement actions, management should carefully consider whether that individual should be associated with the bank's NDIP program.

Training

All personnel involved in the NDIP program should receive comprehensive training for their duties, including continuing education. Sales representatives and investment advisors should fully understand the products offered, and all employees who have direct customer contact should receive basic NDIP program training. That training should address compliance with the Interagency Statement, all applicable laws and regulations, and the bank's sales guidelines.

Bank securities representatives should receive training that is substantially equivalent to the requirements for the appropriate NASD representative designation, including coverage of:

- Product and strategy risks
- Applicable laws and regulations
- Customer protection requirements

Bank personnel who supervise NDIP activity should receive sufficient training to effectively manage the sales

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representatives. NDIP program supervisors should receive training appropriate to that position.

Compensation

Banks may compensate employees for NDIP customer referrals, but the compensation must be:

- A one-time, nominal fee.
- A fixed dollar amount for each referral.
- Paid regardless of whether a sale or new account results.

For example, a bank may pay a fixed dollar fee for every confirmed NDIP customer referral. However, the fee can not be increased if the customer purchases an investment or opens an account. Likewise, the fee can not be reduced if the customer does not purchase an investment or open an account. The referral compensation guidelines apply to all employees that are not specifically authorized to sell or recommend NDIPs.

Sales representatives may receive commissions or incentives for customer transactions, but incentives must not encourage or result in unsuitable recommendations, improper sales, or excessive account transaction activity. Further, independent review personnel or audit staff should never receive incentive compensation related to NDIP sales.

V. DISCLOSURES

Management should ensure that sales representatives and other employees clearly differentiate NDIPs from insured deposits for customers, regardless of the type of NDIP program in place (including networking arrangements). The Interagency Statement declares that NDIP sales disclosures should, at a minimum, clearly indicate that a product is:

- Not insured by the FDIC.
- Not a bank deposit, bank obligation, or guaranteed by the bank.
- Subject to investment risk, including potential principal loss.

However, the Interagency Statement disclosures do not apply to:

- Radio broadcasts of 30 seconds or less.
- Electronic signs (excluding television, internet, or ATMs).
- Signs used only as location indications.

Customer Accounts

Customers should receive the minimum disclosures during every NDIP sales presentation. Oral disclosures may suffice during many sales presentations and when investment advice is offered. However, when a customer opens an investment account, the sales representative should:

- Provide clear written and oral disclosures.
- Fully detail any fees, penalties, or redemption charges.
- Obtain a signed customer statement that acknowledges the customer's receipt and understanding of all disclosures.
- Disclose all material relationships between the bank and any third-party vendors (refer to the Material Relationships section below).

If transaction confirmations or account statements contain the bank (or affiliate) name or logo, then those documents should also include at least the minimum disclosures. If customers' periodic deposit account statements also include NDIP account information, then the NDIP account information should be separate and distinct from the insured deposit

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account information. In addition, the statement should contain at least the minimum disclosures and identify the entity that conducted the NDIP transactions (if the bank used a third-party broker/dealer).

Advertising and Promotion

All retail NDIP advertising and promotions should include the minimum disclosures, and must not misrepresent a product's risks or lack of FDIC insurance. If advertising or promotional material addresses both insured deposits and NDIPs, then the NDIP information and disclosures should be separate and distinct from the insured deposit information. Further, the official FDIC membership statement described in Part 328 of the FDIC's Rules and Regulations should not be used in any NDIP advertising or promotional material. The minimum disclosures apply, but are not limited, to:

- Advertising (all media, including internet)
- Promotional displays on bank premises
- Brochures and other informative materials
- Telemarketing and electronic contacts
- Third-party vendor promotional material

Shorter, logo format disclosures may be used for visual media, including television, ATMs, billboards, signs, brochures, and other written promotional materials. Acceptable logo disclosures should include the following statements:

- Not FDIC Insured
- No Bank Guarantee
- May Lose Value

Third-party vendors, mutual funds, and other NDIP providers will often supply banks with promotional materials, such as placards, brochures, and signs. However, the Interagency Statement's disclosure standards are uniform and do not vary depending upon the entity that produced the material. All NDIP advertising and promotional material displayed on bank premises or provided to customers through bank channels, regardless of its source, should contain the minimum disclosures.

Material Relationships

Sales representatives should disclose significant relationships between the bank, affiliates, and investment firms. Material relationships that should be disclosed include those between:

- Banks or affiliates and an investment company, when the bank or affiliate sells its shares.
- Banks and NDIP sales affiliates.
- Banks or affiliates and proprietary products.

Other Insurance Coverage

Whenever sales activities include a representation regarding insurance coverage not provided by the FDIC, customers may confuse that coverage with FDIC insurance. For example, certain investments may be covered by the SIPC, state insurance funds, or private insurance firms. Sales representatives should clearly distinguish FDIC insurance from any other type of insurance coverage.

Bank and Product Identity

NDIPs must not have a name that is precisely identical to the bank's name. When the bank offers products with names similar to the bank, management should take precautions to prevent customer confusion. Management should ensure that those products are clearly differentiated from the bank's insured deposit products.

Transaction Notification

Part 344 of the FDIC's Rules and Regulations establishes minimum confirmation and recordkeeping requirements

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for banks that sell securities. When a customer purchases a security, the bank must provide either a copy of the broker/dealer confirmation or a written notification of the transaction. Part 344.5 details the information that each notification must contain.

The bank must disclose the amount of any compensation that it received from the customer for each transaction. Further, when the bank receives compensation from any other source for the transaction, then the bank must either:

- Disclose the source and amount of compensation on the transaction notification.
- Include a statement on the transaction notification disclosing that the bank received such compensation and that it will provide the source and amount upon the customer's written request.

VI. SALES SETTING

In order to minimize customer confusion between NDIPs and insured deposits, management should carefully plan the NDIP sales setting and customer contact procedures. Poorly designed sales settings and contact procedures can magnify customer confusion and expose the bank to risk. First, management must physically distinguish the area where NDIPs are sold or recommended from the area where insured deposits are accepted. Second, management should establish procedures for NDIP discussions, referrals, and inquiries that occur outside the designated NDIP sales areas. Bank management is responsible for planning and maintaining the NDIP sales setting, regardless of the type of sales operation in place.

Physical Location

All NDIP sales and recommendations should be conducted in a location that is physically distinct from the retail deposit area. Signs or other indicators should conspicuously identify and segregate the NDIP sales area. Confined facilities or limited lobby space may restrict management's options. In such cases, management should carefully distinguish NDIP activity from retail deposit activity.

Signs for the retail deposit area should not address NDIPs, except for directional indicators. Insured deposit rate boards should not include NDIP information. Rate boards that address NDIPs may be subject to detailed securities laws regarding investment yield advertisements.

Referrals and Inquiries

Management should establish written customer contact procedures for employees that do not sell or recommend NDIPs (for example, tellers and deposit account representatives). All employees with customer contact responsibilities should receive NDIP customer contact procedure training.

Within retail deposit areas, employees should never offer NDIP recommendations, qualify customers for NDIP purchases, or accept NDIP orders. Such activities may blur the distinction between insured deposits and NDIPs. However, any bank employee can refer customers to authorized NDIP sales or advisory personnel.

Within some NDIP programs, bank employees sell both NDIPs and insured deposits. Management should ensure that those employees receive sufficient training to clearly disclose NDIP risks and explain the differences between NDIPs and insured deposits to customers.

VII. SUITABILITY

Sales representatives must employ fair and reasonable investment recommendation and sales methods.

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Representatives must base all investment recommendations on reasonable, objective analysis of each customer's financial condition and investment goals. Employees that are not authorized sales representatives should not recommend specific NDIPs or suggest investment strategy. The board should establish an effective independent review process that regularly assesses sales and investment recommendation practices, regardless of the type of NDIP program in place (including networking arrangements).

Investment Recommendations

Sales representatives should exercise care when recommending investments to retail customers. First, representatives should obtain information detailing each customer's investment goals, financial condition, and other factors. That information should be documented and periodically updated. Next, representatives should evaluate that information, compile customer profiles, and develop reasonable support for all recommendations. Finally, representatives should clearly explain all recommendations to customers.

Representatives can not prudently recommend specific strategies or investments without first evaluating a customer's financial condition and investment goals.

Customer investment goals should serve as the basis for all recommendations, especially:

- Risk tolerance
- Return objectives
- Tax considerations
- Liquidity

Customer financial information should be evaluated, including:

- Assets, liabilities, and net worth
- Income and expenses
- Investment portfolio composition
- Taxation
- Insurance

Customer nonfinancial factors should also be considered, including:

- Age and retirement plans
- Family status
- Current and anticipated education needs
- Current and anticipated health care needs

Unsolicited Transactions

Suitability standards are less stringent for unsolicited transactions and discount brokerage operations. In such circumstances, the sales representative should ensure that the customer has received at least the minimum NDIP and new account disclosures before accepting the transaction. Also, the bank should retain documentation (preferably signed by the customer) that shows the transaction was initiated solely at the customer's request.

Third-Party Vendors

Management should make reasonable efforts to ensure that third-party employees comply with all applicable regulations, the vendor's policies, and bank policies. Management should periodically review regulatory reports (for example: NASD and SEC examination findings), third-party audit reports, and other available materials. In addition, management should carefully review all customer complaints and resolutions. Further, management should evaluate sales representative turnover at bank locations. High complaint or turnover volume may indicate program difficulties. Material problems should be reported to the board, addressed with the vendor, and resolved.

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VIII. PROPRIETARY PRODUCTS

Proprietary products are NDIPs that the bank or bank affiliate advises and markets principally to bank or affiliate customers. Proprietary products can produce greater income for banks than off-the-shelf products, but can also create greater risk exposure. These products expose banks to increased reputation risk, create liquidity and capital considerations, and magnify disclosure concerns. The board and management should adopt detailed policies and procedures to control proprietary products sales.

Program Management

The board should establish policies that guide the management and operations of any proprietary products, and should maintain prudent oversight of proprietary product operations. This oversight should apply to all proprietary products, including those advised by an affiliate. The policies should:

- Require separation of duties between trading, sales, management, and accounting.
- Define bank management's responsibilities.
- Establish an independent review function.
- Outline strategies for potentially significant events, such as a capital injection.

Disclosure

When selling or recommending proprietary NDIPs, sales representatives should clearly disclose the product's risks to customers. Representatives should disclose the minimum information described in subsection V, Disclosures, and should also inform customers of:

- Additional compensation earned for selling a proprietary product rather than other products.
- The product's fee structure, relative to other products offered at the bank.
- The product's risk profile, relative to other products offered at the bank.
- The product's historical performance, relative to other products offered at the bank.

IX. IRAs AND KEOGH ACCOUNTS

Generally, IRAs and Keogh accounts are trust accounts. When offered through a trust department, those accounts should be reviewed during trust examinations. Certain types of IRAs and Keogh accounts require trust powers, including:

- Accounts that appoint the bank as trustee.
- IRAs established by an employer for its employees.
- Keogh accounts that cover additional employees.

Banks may, without exercising trust powers, offer self-directed custodial accounts that are established by individuals for their own benefit. Customers may then choose to invest account funds in NDIPs. Those activities are subject to the Interagency Statement's guidelines and must be examined during regular safety and soundness examinations.

When banks offer and service self-directed IRAs or Keogh accounts, the Interagency Statement's guidelines apply to program management, personnel, disclosures, sales setting, and independent review apply. In addition, the special nature of these accounts demands additional management and control processes.

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Asset and accounting controls must segregate customer assets from bank assets (in both bank and correspondent facilities). Each individual account's assets must be distinguished from other accounts' assets. Accounting records must clearly reflect that segregation, and must be separate from the bank's general ledger. Accounting controls should facilitate proper income reporting, record asset types, and identify individual instruments. Assets held at the bank must be under dual control and should be periodically reconciled or verified. If the bank establishes a nominee partnership for securities registrations and transfers, then management should register the nominee name with the American Society of Corporate Secretaries. This safeguard prevents problems that could occur if more than one bank uses the same nominee name.

Documentation must clearly identify and support each account. IRA documentation should include, at a minimum, the required IRS trust/custodian agreement (Form 5305, 5305A, or equivalent), consumer disclosure agreement, signature card(s), and beneficiary designation.

Suitability guidelines should not apply to self-directed IRAs and Keogh accounts, since all transactions should be unsolicited. If the bank offers investment advice to the customer or acts as trustee, then the account is not self-directed. Management should implement procedures to document or verify that customers do not receive any investment recommendations from the bank.

Illegal investments must not be permitted, regardless of any contrary customer instructions. IRA funds may be invested in United States American Eagle gold coins, but not in collectibles, including art, precious metals, gems, stamps, or antiques. In addition, IRA funds must not be used for certain insider transactions, including:

- Loans to the account sponsor or beneficiaries.
- Collateral for loans to the account sponsor or beneficiaries.
- Purchasing assets from the account sponsor, beneficiaries, or custodian bank.
- Selling assets to the account sponsor, beneficiaries, or custodian bank.
- Investments in debt instruments of the custodian bank or its holding company.
- Investments in equity securities of the custodian bank or its holding company, unless acquired from an independent third-party at fair market value.

Broker selection must be based upon two principles. First, management must select the best broker for the account. Second, under SEC Rule 28(e), brokers must be selected based solely on the combination of lowest possible commission and best possible order execution. Management may not select a broker based on insider relationships, personal relationships, compensation of any type, or solely due to community ties.

Bank brokerage operations present conflicts of interest and considerable risk. A bank can only use its own bank brokerage services for custodial and trustee accounts when:

- Management satisfies securities laws relative to broker selection.
- The customer receives full written disclosure (pursuant to FDIC General Counsel's Opinion Number Six) of the bank's or affiliate's relationship to the broker and all compensation that the bank will earn.
- The account agreement expressly authorizes the specific activity.
- The bank complies with Part 337 of the FDIC's Rules and Regulations, which states that the transactions must be comparable to transactions with an unaffiliated broker/dealer.
- The bank complies with ERISA and Internal Revenue Code provisions stipulating that the bank must either charge no fees, or only charge fees that recover direct costs.
- The bank automatically uses its brokerage for all transactions unless requested to do otherwise, but provides 30-day advance notice to accounts of all fee increases and permits accounts to immediately cease using the bank's brokerage without penalty.

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Independent review functions, in addition to the minimum NDIP guidelines, should:

- Reconcile deposit and suspense accounts.
- Verify assets and recordkeeping.
- Test physical safekeeping and dual control.

When banks offer self-directed IRAs and Keogh accounts but a third-party servicer administers the accounts, the board and management should implement a comprehensive program that adheres to the Interagency Statement's guidelines. Prior to selecting a third-party servicer, the board should evaluate servicers':

- Reputation and experience
- Financial strength
- Regulatory history
- Capacity to service anticipated volume
- Service costs

Management should continue to regularly monitor its servicer, and those reviews should not occur only in preparation for contract renewal. All third-party servicer arrangements should be controlled by a board-approved, written agreement that:

- Permits the bank to review the servicer's regulatory reports and internal audit findings.
- Permits the bank to obtain the source paper files related to its accounts if servicing is terminated.
- Requires the servicer to provide all related computer records in a format compatible with bank and successor servicer systems.

X. INDEPENDENT REVIEW

The board must ensure that NDIP activities comply with all applicable laws and regulations, the Interagency Statement, and bank policies. Independent review depth and scrutiny should depend upon the type of sales program used. Depending upon a bank's size and NDIP activity, an effective independent review program may:

- Evaluate customer complaints and resolutions.
- Analyze exception reports that monitor sales and sales representatives' performance.
- Assess sales representative turnover.
- Investigate unusual redemption patterns.
- Sample customer account files to verify disclosure, suitability, and activity practices.
- Interview customers.
- Employ testers to check disclosure and suitability practices.

When bank employees sell or recommend NDIPs, independent review should also:

- Identify potential conflicts of interest.
- Review separation of duties between sales, supervision, and accounting functions.
- Review suitability processes and sample investment recommendations.
- Evaluate proprietary product operations.

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When the bank has a networking arrangement, independent review should also:

- Ensure that both parties adhere to the written agreement's terms and conditions.
- Verify that third party practices conform with FDIC regulations, the Interagency Statement, and bank policies.

The independent review should be completely separate from the NDIP operation. Independent review staff should not receive any compensation that is based on NDIP sales activity. Review scope and frequency should be determined by independent staff. Findings should be reported directly to the board or a designated board committee (for example, the Audit Committee). Internal and external audit programs should also incorporate NDIP review procedures.

XI. CORE EXAMINATION PROCEDURES

The NDIP examination procedures' two-tier approach maximizes offsite review, streamlines examinations, and focuses resources on potential risks. The procedures permit examiners to verify compliance with the Interagency Statement and applicable regulations. In addition, the procedures enable examiners to evaluate the potential impact of NDIP activity on banks' safety and soundness. There are no questionnaires or checklists that must be completed during an NDIP examination.

The core examination procedures apply to all bank NDIP sales programs. When material violations, weaknesses, or risks are evident, consider implementing the expanded examination procedures for that area. However, expanded procedures should only be implemented for the specific areas that cause examiner concern.

Use judgement and discretion to determine when the examination's scope should be expanded .

OFFSITE REVIEW

The offsite review process incorporates many NDIP examination elements. Many examination procedures may be completed more efficiently during the offsite review, which also reduces the examination resources expended in banks. Obtain all available NDIP information from the bank prior to beginning the examination, including:

- | | |
|---|--|
| ➤ Bank policies and procedures | ➤ Customer disclosure forms |
| ➤ Agreements with third parties | ➤ Training programs materials and records |
| ➤ Independent review policies and reports | ➤ Other regulatory reports |
| ➤ NDIP activity and financial reports | ➤ Qualifications of all NDIP program personnel |
| ➤ All available promotional materials | ➤ Proprietary product management reports |
| ➤ Customer complaints and resolutions | |

Other regulators' reports and findings should be obtained from the bank. When necessary, under a 1995 Memorandum of Understanding between the FDIC and the NASD, FDIC examiners can obtain the examination findings and workpapers from the most recent NASD examinations of bank-affiliated broker/dealers. FDIC Regional Offices are responsible for contacting the appropriate NASD regional office and establishing information sharing procedures. NASD information should be requested prior to beginning pre-examination planning to ensure that it is available for offsite review. Use the above material to complete as many of the following examination procedures as possible before commencing the onsite examination.

PROGRAM MANAGEMENT

The board and management should adopt, implement, and maintain an effective NDIP program. Refer to subsection III, Program Management, for additional information. Evaluate the board's oversight and control of the NDIP program.

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PROCEDURES

The board should:

- Establish clear goals for the NDIP program.
- Periodically assess the NDIP program's risks and rewards.
- Adopt prudent policies that guide NDIP management and operations.
- Establish an effective system to document and resolve customer complaints.
- Authorize specific employees to recommend and sell NDIPs.
- Authorize specific officers to supervise the NDIP program.
- Periodically review and, if necessary, act upon the NDIP independent review reports.

Assess management's implementation of the NDIP program. Management should:

- Comply with the board's policies.
- Comply with applicable laws, regulations, and the Interagency Statement.
- Ensure safe and sound NDIP operations.
- Establish prudent NDIP procedures and controls.

When the bank has a networking arrangement with a third-party vendor:

- The arrangement should be controlled by a written agreement.
- The agreement should be approved by the board.
- The agreement should comply with all laws, regulations, and the Interagency Statement.
- The agreement should indemnify the bank from the third party's NDIP activities.
- The agreement should provide for bank oversight, including the authority to remove sales representatives from bank premises.

If the NDIP program does not include satisfactory board oversight, management supervision, policies, controls, and independent review, then NDIP activities may create safety and soundness concerns. When the standard examination procedures identify material program weaknesses or safety and soundness concerns, implement the expanded examination procedures.

PERSONNEL

NDIP personnel should meet minimum qualification and training standards, which are detailed in subsection I V (Personnel). Determine if:

- NDIP representatives and management are qualified to conduct their authorized duties.
- The NDIP training program provides adequate continuing education.
- Compensation policies and procedures comply with applicable laws, regulations, and the Interagency Statement.
- Independent review adequately addresses personnel and compensation.

If personnel qualification, training, or compensation practices do not meet the standards described in subsection IV, then implement the expanded examination procedures.

DISCLOSURES

Complete, accurate NDIP disclosures can significantly reduce customer confusion and potential risk. Refer to subsection V, Disclosures, for additional information regarding disclosure requirements. Verify that all disclosures contain at least the minimum required content. Evaluate the NDIP program's standard materials, including:

- Customer account disclosure forms
- NDIP account statements

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- Sales confirmations
- Advertising and promotional material

Verify that the NDIP program mandates at least the minimum disclosures. Review the written policies, procedures, and independent review reports. Written policies and procedures should require:

- Disclosure training for all NDIP personnel.
- Minimum disclosures during all NDIP sales presentations.
- Minimum disclosures for all NDIP advertising and promotions.
- Representatives to obtain a signed customer statement that acknowledges the customer's receipt and understanding of all disclosures before opening a new account.
- Comprehensive independent review.

Review all customer complaints in the NDIP program's files and in FDIC files. Determine if the complaints suggest a pattern of inadequate disclosure. If such a pattern is evident, then implement the expanded examination procedures.

The core procedures do not include customer account file review. When file review appears necessary, implement the expanded procedures (which incorporate customer account file review). Use judgement and discretion to determine when to implement the expanded procedures.

If the board and management have not adopted effective policies and procedures to provide at least the minimum disclosures, then implement the expanded examination procedures. Further, if the independent review reports suggest that the NDIP customers do not receive adequate disclosures, then implement the expanded procedures.

SALES SETTING

Management must take every reasonable precaution to eliminate customer confusion between the NDIP and retail deposit settings and operations. Refer to subsection VI, Sales Setting, for additional information. When examining the NDIP sales setting:

- Verify that policies and procedures require strict segregation between NDIP and retail deposit activity.
- If hybrid accounts are offered, determine if management has established clear written policies and controls.
- Verify that NDIP names are **not** identical to the bank's name.
- Determine if the training program provides education regarding maintaining segregation between the NDIP and retail deposit areas.
- Determine if the NDIP sales areas are clearly segregated from retail deposit areas. In banks with multiple NDIP sites, evaluate a small sample of the NDIP sales locations.
- Verify that the independent review reports address the NDIP sales setting and that exceptions have been corrected.
- Review all customer complaints and determine if they indicate a pattern of consumer confusion regarding NDIP sales settings.

When management has not established NDIP sales areas that are physically distinct from the retail deposit areas, implement the expanded procedures.

SUITABILITY

Sales representatives can not prudently recommend specific investments without evaluating a customer's financial condition and investment goals. Evaluate management's policies and controls, independent review, and customer complaints, rather than samples of individual recommendations to customers. Refer to subsection VII, Suitability, for additional information. Determine if:

- Customer complaints indicate a pattern of unsuitable recommendations.

NONDEPOSIT INVESTMENT PRODUCT EXAMINATION

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- Policies and controls require representatives to evaluate sufficient customer information before offering investment recommendations.
- Policies and controls require representatives to clearly explain all recommendations to customers.
- The independent review includes thorough suitability coverage.

The core procedures do not include customer account file review. When file review appears necessary, implement the expanded procedures (which incorporate customer account file review). Use judgement and discretion to determine when to implement the expanded procedures.

If the suitability policies, controls, or practices demonstrate weakness or indicate customer confusion, then implement the expanded examination procedures.

PROPRIETARY PRODUCTS

The board should oversee all proprietary product activities and establish policies that guide the management and operations of any proprietary products. Sales representatives should understand the proprietary products and clearly disclose those products' risks, fees, and commissions to customers. Independent review should verify sound operations and appropriate disclosures. Refer to subsection VIII, Proprietary Products, for additional guidance.

Determine if the proprietary products present potential risks by:

- Evaluating policies, procedures, board oversight, and management supervision.
- Reviewing other regulatory reports for findings that may affect the bank's safety and soundness.
- Verifying that policies and procedures require sales representatives to clearly disclose proprietary products' risks, fees, and commissions.
- Determining independent review adequacy.

If proprietary products have inadequate board oversight, management, sales disclosures, or independent review, then implement the expanded examination procedures.

INDEPENDENT REVIEW

Independent review should ensure that the NDIP program complies with all laws, regulations, the Interagency Statement, and internal policies and procedures. Refer to subsection IX, Independent Review, for additional information. Determine if the independent review:

- Maintains complete independence from the NDIP program.
- Identifies potential conflicts of interest.
- Monitors customer complaints and resolutions.
- Verifies that third-party sales adhere to the agreement with the bank, applicable laws and regulations, and the Interagency Statement.
- Ensures that disclosure policies, procedures, and content comply with applicable laws, regulations, and the Interagency Statement.
- Samples customer files to verify that signed disclosure statements are obtained.
- Reviews all advertising and promotions for compliance with applicable laws, regulations, and the Interagency Statement.
- Scrutinizes the suitability process and sample customer account files.
- Evaluates proprietary product operations.
- Compiles regular reports.

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- Reports directly to the board or designated committee.

If the independent review function does not adequately assess and report compliance to the board, then implement the expanded examination procedures.

XII. EXPANDED EXAMINATION PROCEDURES

The expanded examination procedures direct increased scrutiny on specific areas of NDIP activity that present additional risk. The entire set of expanded procedures should not be applied automatically. Rather, implement only the expanded procedures that address specific areas of weakness, concern, or potential risk.

When material supervisory concerns are evident, consider contacting a SRCMSS or RCMSS for additional guidance.

PROGRAM MANAGEMENT

When the core examination procedures identify NDIP program weaknesses, those weaknesses may negatively impact the bank's safety and soundness. Discuss all weaknesses in detail with management, suggest corrective action, and assess management's commitment to correct all deficiencies. If NDIP program management creates potential safety and soundness risk or management is unwilling to correct the program's deficiencies, then formal corrective action may be warranted.

PERSONNEL

When management's policies, procedures, and independent review do not appear to provide for a qualified, well-trained NDIP staff:

- Review sales representatives' files and assess their backgrounds and regulatory histories. If management does not maintain that information on file, they should obtain it for the examination and for internal review.
- Assess the bank's NDIP training materials.
- Sample compensation practices to verify that management adheres to all applicable laws, regulations, the Interagency Statement, and board policy.
- Review sales records and ensure that only specifically designated personnel sell NDIPs.
- Review referral practices and verify that management adheres to all applicable laws, regulations, the Interagency Statement, and board policy.
- Interview various branch employees, including tellers and receptionists, and determine if proper NDIP referral procedures are followed.
- Discuss all concerns with management and determine their commitment to correct any deficiencies.

DISCLOSURES

When the core procedures indicate that customers may not receive adequate NDIP disclosures:

- Sample customer account files and verify that the required disclosures are included.
- Review **all** available advertising and promotional material.
- Visit several NDIP sales locations (when practical), evaluate the NDIP promotional material, and sample customer information.
- Interview sales representatives and gauge their knowledge of and commitment to adequate disclosure.
- Discuss all concerns with management and determine their commitment to correct any deficiencies.

Do not pose as a potential NDIP customer or employ testers in order to assess the disclosure process. When a

NONDEPOSIT INVESTMENT PRODUCT EXAMINATION

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pattern of inadequate disclosure is evident, corrective action may be warranted.

SALES SETTING

When the core procedures indicate that the NDIP sales setting may create customer confusion between NDIPs and insured deposits:

- Visit additional NDIP sales locations (when practical) and determine if the NDIP sales setting is physically distinct from the retail deposit area.
- Discuss all concerns with management and determine their commitment to correct any deficiencies.

When the sales settings do not clearly distinguish the NDIP sales area from the insured deposit area, assess the potential for customer confusion.

SUITABILITY

Implement these procedures when the core procedures reveal that suitability practices or controls create customer confusion or potential risk. Assess the extent of suitability problems and potential risk exposures, but do not judge the appropriateness of individual recommendations to customers or suggest alternatives. Contact a SRCMSS or RCMSS for guidance before commencing these expanded suitability procedures.

Analyze sales reports and promotions to:

- Evaluate sales activity for questionable practices, such as account churning.
- Determine if promotions have prompted unsuitable recommendation practices. For example, high volumes of volatile instruments or dramatic increases in a particular product's sales may indicate suitability concerns.

Sample customer files and determine if:

- Customers signs appropriate disclosure forms.
- Representatives document and review adequate customer information before offering investment recommendations.
- Customer data has been updated periodically.
- Representatives provide complete information to customers regarding potential risks.
- Recommendations conform to customer goals.

Determine the potential risk from customer confusion or unacceptable investment recommendation practices. Do not pose as a potential NDIP customer or employ testers in order to assess the suitability process. Discuss all concerns with management and determine their commitment to correct any deficiencies.

PROPRIETARY PRODUCTS

When the core procedures indicate that a proprietary product may create potential risk:

- Sample customer account files and verify that proper disclosures are included.
- Evaluate management's policies, procedures, and ability relative to potential cash injections or liquidity problems.
- Analyze other regulatory reports (for example, NASD, SEC, or state insurance commissioner examinations) to assess any operational risks.

INDEPENDENT REVIEW

When core examination procedures illustrate inadequate independent review:

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- Sample customer account files and evaluate the independent review's success at identifying and eliminating documentation deficiencies.
- Determine if the independent review tracks all customer complaints and reports its findings to the board.
- When possible, verify the accuracy of the independent review's reports to the board.
- Interview NDIP staff and assess the independent review's oversight presence.
- Discuss all concerns with management and determine their commitment to correct any deficiencies.

XIII. EXAMINATION CONCLUSIONS

SAFETY AND SOUNDNESS ASSESSMENT

Well-managed NDIP programs should augment bank earnings, and may help maintain or expand banks' customer bases. However, NDIP activities can create safety and soundness concerns regarding:

- Contingent liabilities
- Reputation
- Earnings
- Liquidity

Contingent Liabilities

Determine if NDIP activities create current or potential contingent liabilities that can negatively affect earnings or capital. Incorporate that analysis, when material, in the earnings, capital, and contingent liability assessments. Consider:

- Settled, pending, and planned customer complaints or litigation.
- Regulatory investigations and sanctions.
- Failure to document minimum disclosures.
- Inappropriate product suitability or investment recommendation practices.

Reputation

When a bank's NDIP activities erode customers' or the marketplace's confidence in that institution, the bank's reputation may suffer. This could result from poor disclosures, inappropriate investment recommendations, or even fraudulent practices. In addition, reputation risk may develop for no discernable reason. As a result, reputation risk is impossible to quantify. Still, the safety and soundness assessment must incorporate potential reputation risk from NDIP activity. Potential reputation risk may provide additional support for component and composite ratings.

Earnings

Determine if NDIP activities can materially impact earnings and incorporate the analysis in the examination's earnings assessment. Consider:

- NDIP program income, expenses, and stability relative to bank earnings.
- Deposit migration to NDIPs and funding costs.

Liquidity

Determine if NDIP activities can materially impact liquidity and incorporate that analysis in the examination's liquidity assessment. Focus the analysis on two factors:

- Actual or potential deposit migration to NDIPs.
- Proprietary product liquidity concerns.

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Incorporate the NDIP analysis into the safety and soundness assessment, including the composite rating and all applicable component ratings. Material NDIP findings and analysis may be included in the Examiners Conclusions and Comments. Address any NDIP program deficiencies in the Management and Administration, Risk Management, Internal Routine and Controls, and Violations sections of the Report of Examinations.

APPARENT SECURITIES LAW VIOLATIONS

Apparent violations of securities laws by bank-affiliated broker/dealers should be referred to the NASD. Each FDIC Regional Office has the responsibility for providing this information to the appropriate NASD regional office.